19-Jul-2019

Regions Financial Corp. (RF)

Q2 2019 Earnings Call

CORPORATE PARTICIPANTS

Dana W. Nolan
Executive Vice President & Head-Investor Relations, Regions Financial Corp.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

Barbara I. Godin
Executive Vice President, Consumer Banking Credit Executive, Regions Financial Corp.

John B. Owen
Chief Operating Officer & Senior Executive Vice President, Regions Financial Corp.

OTHER PARTICIPANTS

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

John Pancari
Analyst, Evercore ISI

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.

Jennifer Demba
Analyst, SunTrust Robinson Humphrey, Inc.

Peter Winter
Analyst, Wedbush Securities, Inc.

Ken Usdin
Analyst, Jefferies LLC

Erika Najarian
Analyst, Bank of America Merrill Lynch

Saul Martinez
Analyst, UBS Securities LLC

Christopher William Marinac
Analyst, Janney Montgomery Scott LLC.

Kevin J. Barker
Analyst, Piper Jaffray & Co.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Regions Financial Corporation's Quarterly Earnings Call. My name is Shelby, and I'll be your operator for today's call. I would like to remind everyone that all participant phone lines have been placed on listen-only. At the end of the call, there will be a question-and-answer session. [Operator Instructions]

I will now turn the call over to Dana Nolan to begin.

Dana W. Nolan

Executive Vice President & Head-Investor Relations, Regions Financial Corp.

Thank you, Shelby. Welcome to Regions second quarter 2019 earnings conference call. John Turner will provide highlights of our financial performance and David Turner will take you through an overview of the quarter. The slide presentation as well as our earnings release and earnings supplement are available under the Investor Relations section of our website.

Our forward-looking statements disclosure and non-GAAP reconciliations are included in the appendix of today's presentation and within our SEC filings. These cover our presentation materials, prepared comments as well as the question-and-answer segment of today's call.

And, with that, I will now turn the call over to John.

John M. Turner, Jr.

President, Chief Executive Officer & Director, Regions Financial Corp.

Thank you, Dana, and thank you all for joining our call today. Let me begin by saying in the face of significant market volatility, we're pleased with our second quarter results. We reported earnings from continuing operations of $374 million, a 3% increase over the second quarter of the prior year and earnings per share of $0.37, an increase of 16%. We also delivered solid pre-tax, pre-provision income growth compared to the prior year and generated 4% adjusted positive operating leverage.

This quarter's results demonstrate our core business remains strong and our focus on meeting client needs is producing sustainable growth. We grew revenue, average loans and deposits, and new customer relationships across our markets, while reducing expenses.

We're also experiencing success in our priority markets, which include Atlanta, Houston, Orlando and St. Louis. For example, in Atlanta, the pace of new account and deposit growth is approximately two times better than that of the total company. Further, we're outperforming the general market in terms of household account growth in each respective location.

Shifting to the corporate bank, in just six months, we've added a significant number of new clients across these same markets. Commercial banking growth has been particularly strong in Houston, where pipelines for credit and deposits are at an all-time high. Although it's early, we believe these facts provide evidence that our investments for growth are paying off. We remain focused on those things we can control and we continue to feel very good about our future.

We're largely complete with our hedging strategy that we began about 18 months ago. These instruments will provide stability to our net interest income and net interest margin. And David will spend some time discussing the details of that strategy in just a moment. We also remain well positioned to prudently manage through the next credit cycle because of our ongoing risk mitigation activities, including client selectivity, sound underwriting, rigorous credit servicing, and appropriate concentration limits.

We remain focused on appropriate capital allocation, balance sheet optimization and risk-adjusted returns. This work led to our exit of indirect auto insurance and the decision to exit a point-of-sale relationship earlier this year. It also informed our strategic decision to achieve better balance between construction and term commercial lending within our real estate business, another meaningful example of our commitment to build a business that's sustainable over the long term.

This quarter, we repositioned a portion of our investment securities portfolio, continued to focus on client selectivity and relationship profitability with our loan portfolios, and improved our funding mix. These actions will help support net interest income and the net interest margin going forward.

Despite recent market uncertainty, the economy still feels pretty good. And while our customers are more cautious than they were just a few months ago, they maintain a positive outlook and most continue to expect better performance this year than last. Many of our customers have a backlog of orders with the biggest challenge being an insufficient supply of skilled labor. Fundamentally, the domestic economy remains solid and credit quality continues to reflect relatively stable performance with some continued normalization.

And while lower interest rates support continued economic expansion, they will certainly pressure future revenue growth. To respond, we will continue to build on the momentum we've established through our Simplify and Grow initiative to make banking easier, accelerate revenue growth, and importantly become more efficient and effective.

Should the market's current path for lower interest rates persist with short rates declining in the second half of 2019 and remaining at lower levels into 2020 and the economy softens faster than we expect, achieving some of our long-term financial targets will be challenging. That being said, we remain committed to doing all we can to appropriately adjust our plans and to respond.

So, to summarize, this was another solid quarter for Regions and despite the market volatility and uncertainty, I feel good about where we are today and believe we're well positioned to generate consistent and sustainable long-term performance throughout all phases of the economic cycle.

With that, I'll now turn it over to David.

David J. Turner, Jr.

Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

Thank you, John. During last quarter's call, we spent time talking about certain balance sheet optimization efforts that were either underway or actively being developed. And today I want to spend a few minutes highlighting the results of those efforts. When we say balance sheet optimization, we're referring to the strategies we execute every day to challenge the efficiency of our balance sheet in order to maximize net interest income and margin, as well as overall profitability and returns.

This quarter, adjusted average loans grew approximately 1%. As you may recall, late last quarter, we experienced loan growth from certain large corporate customers that, while high in quality, generated thinner spreads. We anticipated some of these customers would choose to refinance in the capital markets. Although we have experienced some movement, the moderation in loan growth this quarter was primarily due to our continued focus on client selectivity and overall relationship profitability.

As John mentioned, loan demand in our markets remained reasonably healthy, but maintaining our disciplined approach impacted overall balance growth. We remain focused on risk-adjusted returns and are not interested in trying to outgrow the economy by pursuing nominal loan growth for short-term benefit. With that said, we continue to expect full year growth in average adjusted loans to be in the low- to mid-single digits.

During the quarter, we also executed strategies to better optimize our securities portfolio. We reduced the overall size by approximately $1.5 billion through a combination of maturities and sales. We also sold another $2.8 billion of lower yielding securities and reinvested those proceeds into higher yielding securities, improving our yield run rate by 8 basis points, while recognizing approximately $19 million of net losses. The new securities were selected to ensure appropriate prepayment protection with a focus on improving performance in a declining rate environment.

Turning to the liability side of the balance sheet, average corporate segment deposits decreased 3% during the quarter and included seasonal declines within public fund accounts, as well as an intentional exit of approximately $700 million of higher cost deposits that were added during the first quarter to support loan growth. Despite this reduction, total average deposits still increased approximately 1%, driven primarily by growth in consumer.

Exhibiting the strength of our core deposit franchise, average consumer deposits increased $1.3 billion and, importantly, average non-interest-bearing consumer deposits increased almost $600 million. These optimization strategies also triggered a reduction in wholesale funding needs during the quarter. Average FHLB advances are down approximately $1 billion compared to the prior quarter.

So, let's look at how this impacted net interest income and margin. Net interest income was down slightly compared to the first quarter and net interest margin totaled 3.45%. As expected, continued deposit pricing pressure was the largest driver of this quarter's margin.

What is important to note, however, is we did see deposit costs peak within the quarter in May and subsequently trend down in June. Our total deposit costs remain one of the lowest in the industry, and our cumulative deposit beta for the recent tightening cycle is 29%. Assuming the Federal Reserve begins to ease in orderly increments of 25 basis points, we currently expect an initial deposit beta of approximately 35% at the beginning of a down-rate cycle.

In addition to deposit costs and after normalizing for days, another driver to this quarter's margin was declining market interest rates. This includes the decline we saw in LIBOR in anticipation of potential rate cuts by the Federal Reserve as well as the decline in long-end rates. Currently, the market is pricing in further interest rate declines over the second half of 2019. So, let's spend a few minutes looking at how this could impact our results.

While reducing deposit costs would provide some relief, using the June 30 market forwards which include roughly three 25 basis point reductions, we would expect full year net interest income to be modestly higher than the prior year, while fourth quarter margin would approach 3.40%, the low end of our long-term range. However, we would expect the first quarter's margin to expand into the low-to-mid-3.40s as the benefit of our forward starting hedges begin.

Now I want to take some time and walk you through our hedging strategy and its expected financial benefit. Slide 6 contains additional details regarding our use of forward starting swaps and floors along with their anticipated impact to our future asset sensitivity profile. The chart provides a cumulative build of the notional value of our hedges broken out by the quarter in which they become effective. We are substantially complete with our hedging program and, importantly, the bulk of those forward starting hedges become active on January 1, 2020.

In addition, these forward starting hedges have maturities of approximately five years from their respective start dates. These longer tenors provide better support to future net interest income to the extent rates remain low for an extended period. Because the preponderance of our hedging program is forward starting, many of you may be modeling a negative impact to our future net interest income that will look markedly different six months from now.

To illustrate the benefit of our future dated hedges, we have provided the estimated impact to annual net interest income associated with a standard 100 basis point gradual, parallel shock for each future period presented. The table highlights this inverted relationship. As our forward starting hedges become effective, our asset sensitivity is reduced. The key takeaway from this slide is our forward starting hedges will stabilize our interest rate sensitivity profile in 2020 and beyond.

So, let's move on to fee revenue. Adjusted non-interest income increased 2% compared to the first quarter. Service charges, card and ATM fees, and mortgage reflected seasonally higher revenue combined with continued customer account growth and an increase in transaction activity. Wealth management income increased primarily due to sales and market-driven revenue from investment management and trust, combined with higher sales volume from investment services. Within mortgage income, our net MSR hedge impact remained relatively consistent quarter over quarter.

However, as expected, in a declining rate environment we are beginning to experience an increase in prepayment decay. Partially offsetting these increases were declines in capital markets, bank-owned life insurance and other non-interest income. The decline in capital markets was primarily due to lower M&A advisory fees and customer swap income. The decline in customer swap income was almost entirely due to market-related credit valuation adjustments tied to customer derivatives. Excluding these market-based adjustments, total capital markets income would have increased approximately 5%.

Let's move on to non-interest expense which continues to be a really good story for Regions. Adjusted non-interest expense increased 1% compared to first quarter. Furniture and equipment expense, outside services and professional fees increased this quarter, but were partially offset by a decline in salaries and benefits.

A decline in staffing levels of just under 300 full-time equivalent positions combined with a favorable reduction in benefits expense contributed to the decline in salaries and benefits. The adjusted efficiency ratio was 58.3%, unchanged from the prior quarter. Despite success in managing our costs, the challenging revenue environment necessitates even more focus on expense management.

One area with expense save opportunity is within corporate real estate. This quarter we took advantage of market opportunities and sold a large office building in excess of 100,000 square feet. We also made a decision to market the sale of another large office building in excess of 300,000 square feet. These transactions will benefit future occupancy expense and are expected to help us exceed our goal to reduce over 2 million square feet of space by 2021.

Additionally, we continue to make significant progress in the digital space. Digital checking account openings are up 53%, and digital card production is up 43% year to date. The effective tax rate was 19.4% and was impacted by excess tax benefits associated with vested equity awards.

So, let's shift to asset quality. Asset quality continued to perform in line with our expectations this quarter and reflected stable performance within a relatively benign credit environment. While some normalization of certain credit metrics continued, overall credit results remained well within the acceptable range of our established risk appetite.

Net charge-offs increased to 0.44% of average loans, in line with our expected range of 40 to 50 basis points for 2019. Provision matched net charge-offs, resulting in an allowance equal to 1.02% of total loans and 160% of total non-accrual loans. Non-accrual loans increased modestly, while business services criticized loans remained relatively unchanged and total troubled debt restructured loans decreased 7%. While overall asset quality remains stable and within our stated risk appetite, volatility in certain credit metrics can be expected.

So, let me give you some brief comments related to capital and liquidity. During the quarter, the company repurchased 12.8 million shares of common stock for $190 million and declared $141 million in dividends. In June, we announced details related to our 2019 capital plan. We intend to reach our 9.5% Common Equity Tier 1 ratio target in the third quarter and manage at that approximate level going forward.

Our capital plan includes the ability to repurchase up to $1.37 billion of common stock; however, the exact amount and timing of repurchases will be determined by actual loan growth and our overall financial performance. We also expect to increase the quarterly dividend within our stated range of 35% to 45% of earnings. The board will consider this increase at their meeting next week.

Our full year 2019 expectations are presented on slide 11. Assuming the market forward curve at quarter end, we would expect to be at the lower end of our 2% to 4% full year adjusted revenue growth target. Given the uncertain revenue environment, we are increasing our focus on expense management and expect full year adjusted non-interest expense to be stable to down slightly. And we expect to generate positive operating leverage for the year.

As John noted, we remain focused on the things we can control and we are responding to the changing market dynamics as we have in the past. So, in summary, we are pleased with our second quarter financial results. We have a solid strategic plan designed to deliver consistent and sustainable performance throughout any economic cycle.

With that, we're happy to take your questions. We do ask that you limit them to one primary and one follow-up question. We will now open [audio gap] (00:20:09).

QUESTION AND ANSWER SECTION

Operator: Thank you. The floor is now open for questions. [Operator Instructions] Your first question comes from Ryan Nash of Goldman Sachs.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

Q

Good afternoon, guys.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Ryan.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

Q

Hey. Good morning, guys. So, it looks like you've seen an inflection in deposit costs, although at 29% you had one of the lowest beta cycle to date. So, you're talking about the NIM approaching 3.40% and then increasing. Can you just talk about how you feel about your ability to bring down deposit costs across retail, wealth and commercial? And then, as you think about the sensitivities you've outlined, given all the changing dynamics on the balance sheet, how do you think about the sensitivity to short- versus long-term rates? And then, I have a follow-up.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Okay. This is David. So, yeah, I mean we're encouraged by the reaction of our teams on deposit cost. We clearly are competitive, but we're able in the month of June, through our actions we took the month before that to reduce deposit cost couple of basis points. And we've put that in a chart to show you that we expect that to have already peaked. To the extent that we continue to get short-term rates down, that will give us even more ability to reduce deposit costs.

We have about 10% of our deposits are indexed – 10% of our interest-bearing deposits are indexed, but we also have another 10% of our interest-bearing deposits that have been exception priced or really money market type deposits that we get to address as rates change. So, we can move pretty quickly as the market changes, which gives us some confidence that we continue to hold our margin at that 3.40% level for the remainder of the year, even if we get the two, roughly three cuts that the forwards imply.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC

Q

Got it. And maybe as my follow-up, you talked about the environment being challenging and it might be hard to hit some of your targets. I guess if the rate environment does improve, do you think you could still approach the low end of your efficiency and RoTCE targets? And then, second, do you expect to continue to be able to generate positive operating leverage, even if you don't hit the targets? Thanks.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. So, we made a commitment at Investor Day that we would generate positive operating leverage each year of our three-year plan. Clearly, the rate outlook puts some pressure on that, but we still are committed to generating positive operating leverage. If you recall, the last three-year plan that we had, the market didn't behave quite like we thought it was going to either. And we pulled whatever it took to make sure we met the targets, and so we have confidence in that. Clearly, if we have a persistent low rate environment for this whole three-year period, that does put pressure on certain of those metrics.

But I would like to point out, we're six months into our three-year plan. There are a lot of things that can happen. And so, we're confident we have a good plan that we have the ability to toggle and do what we need to do to continue to improve our financial performance, and we will do that. That was the commitment that was in our prepared comments, both from John and from me.

Ryan M. Nash
Analyst, Goldman Sachs & Co. LLC
Q

Got it. Thanks for taking my question.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Thank you.

Operator: Your next question comes from John Pancari of Evercore ISI.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Morning, John.

John Pancari
Analyst, Evercore ISI
Q

Good morning. On the expense topic still, just I guess longer term you had a expectation for a below 55% efficiency ratio in 2021 or by 2021. Can you just let us know how you're thinking about that level and if it's still attainable despite the rate backdrop just given your hedging, et cetera? Thanks.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. So, as I tried to mention to Ryan then, three years is a long time. If you just did the math on this rate persisting for that entire three-year period of time, it would be pretty hard to get to a 55% efficiency ratio because what we don't want to do is cut our expenses so much we damage our franchise. We can get pretty close to that even in that rate environment because of all the hedging that's in place. But could we hit 55%? It'd be – again, this rate environment persisting the entire time would be pretty tough.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

But I would say, John, I mean we're going to remain focused on effective expense management, while investing in our business. And so, you can expect us to continue to deliver on our commitment to maintain expenses to flat to down slightly, while investing in our business and hopefully growing revenue despite what is a challenging interest rate environment.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

And let me add something to that, John, because we're talking about the interest rate environment. If we have a low rate environment with slope to the yield curve, that's very helpful. If we have, obviously, a higher rate environment with a slope that's ideal, a low and flat rate environment is where we would have pressure on that 55% margin.

John Pancari
Analyst, Evercore ISI

Q

Got it. Okay. That's helpful color.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

I'm sorry, efficiency, yeah.

John Pancari
Analyst, Evercore ISI

Q

Right, right. Got it. Okay. And then, my follow-up is around credit. Just wanted to see if we can get a little bit more color on the increase in charge-offs on the commercial front where they came from. And then also your non-performers still saw a moderate increase in the quarter despite the higher charge-offs, so implying that we're seeing a pickup in inflows here. Could you talk about what is driving that? Thanks.

Barbara I. Godin
Executive Vice President, Consumer Banking Credit Executive, Regions Financial Corp.

A

Sure. It's Barb. Relative to charge-offs that was driven by one loan, it was in the – come out of the healthcare sector, it's something that we have been working on for quite a while and finally came to a resolution. So, we don't see anything systemic in there. Relative to the NPLs, it was three loans that really drove those numbers, of which one has since been paid off. And the other two, at this point we don't expect any loss from them, so again nothing systemic. We're still seeing credit as being stable in our outlook going for the balance of the year. And we're committed to get to the 40 to 50 basis point range again for the balance of the year.

John Pancari
Analyst, Evercore ISI

Q

Okay, great. Thank you.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

Operator: Your next question comes from Matt O'Connor of Deutsche Bank.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Morning, Matt.

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.
Q

Hi. There are some puts and takes on the balance sheet and kind of outside of loans you talked about balance from securities, reinvesting them. Just as we think about earning assets ex loans, are those kind of relatively stable going forward with the restructuring? I just want to make sure I've got all the puts and takes there.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. Matt, I would tell you some of those investment transactions were toward the end of the quarter. So, if you look at our average, our average is below what the ending was. So, we're going to feel a little bit of pressure on earning assets from that trade into the third quarter. So, it's really not as much on growing net interest income and margin on earning assets as it is of the mix and being able to react to deposit pricing should we have rate reductions.

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.
Q

Okay. So, the buckets of kind of non-loan earning assets will be down a bit on average 3Q versus the 2Q level.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

In particular in the investment security portfolio because that trade has happened in this quarter.

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.
Q

Yeah. Yeah. Okay. And then now just following up on the line of credit discussion right before me, the early stage delinquency numbers also moved up. And did that relate to the healthcare loan or the commercial inflows, one of which paid off, or was that driven by something different?

Barbara I. Godin
Executive Vice President, Consumer Banking Credit Executive, Regions Financial Corp.
A

Yeah. Part of that is seasonal in our 30-day buckets. 90-day buckets were down. 30-day was up marginally. And there was nothing systemic in there at all. That is, as we said, part and parcel of our seasonality.

Matthew Derek O'Connor
Analyst, Deutsche Bank Securities, Inc.
Q

Okay. All right. Thank you.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Thank you.

Operator: Your next question comes from Jennifer Demba of SunTrust.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning.

Jennifer Demba
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thank you. Good morning. Question for you on M&A. Could you just give us an idea of what your interest level is at this point in bank and non-bank M&A?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Yeah. Thank you. Our interest in bank M&A hasn't changed. We remain focused on the execution of our plans. We don't see any material change in the economic analysis of bank M&A. And so, we're going to continue to watch the market. We're going to continue to pay attention to what's occurring, but our position hasn't changed.

With respect to non-bank M&A, we continue to look for opportunities to add capabilities to help grow and diversify revenue, to meet customer needs. We recently announced the acquisition of Highland which is a wealth management capability that's complementary to our healthcare business and one that we're excited about. It's a smaller transaction like the others that we have done, but is meaningful. And then, again, it helps us, we think, grow and diversify our revenue and meet the customer needs by adding some capabilities.

We have been actively looking at mortgage servicing rights acquisitions. But with the rate environment, those transactions have become more challenging to find, but we'll continue to do that. And within our other businesses, we're again always looking for opportunities to add to our capabilities and we'll remain active there.

Operator: Your next question comes from Peter Winter of Wedbush.

Peter Winter
Analyst, Wedbush Securities, Inc.

Q

Good morning.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Morning.

Peter Winter
Analyst, Wedbush Securities, Inc.

Q

Yeah. You guys are putting a little bit more emphasis on the expense side. I was just wondering if you could talk about some of the levers because it certainly doesn't seem like you're going to slow down the investments.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. Peter, that last statement is really important because we are continuing to look for ways to make banking easier for our customers looking to make investments in talent and technology, and we have to pay for that. And the way to do that is to continue to focus on our expenses and leverage our Simplify and Grow continuous improvement program that we started a little over a year-and-a-half ago.

If we're going to control our expenses, we have to really have an intense focus on our top three categories, salaries and benefits being number one, we're down some 300 positions this quarter. We continue to look to opportunities to streamline operations by leveraging technology and most of that gets handled through attrition. We've looked at occupancy as our next biggest category. As we had in our prepared comments, we had some 400,000 square feet of space that we're exiting. Some of it we have exited. Some of it we just put in held for sale, and we will be getting out of that space to save us on run rate occupancy.

Also, furniture, fixtures and equipment, our third category; as we have fewer people, we have smaller space, we can save there as well. That probably through our fourth category would be kind of purchasing vendor spend, if you will. We have a – I do have a procurement that has really put in a lot of rigor in terms of helping us from a demand management standpoint on controlling what we need from a purchasing standpoint, whether it be consulting hours or products or whatever the case may be. And so, in this type of challenging revenue environment and a commitment to positive operating leverage, you just have to pull every string that you can in terms of controlling expenses.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

And I'd add, Peter, as we've said a few times, we're really pleased with our Simplify and Grow initiative and we're really only beginning to see the benefits of the continuous improvement work that's occurring. And I'd ask John Owen who has led that initiative just to briefly talk about a couple of other things that – opportunities that we see through the use of our digital capabilities to drive improvement. John?

John B. Owen
Chief Operating Officer & Senior Executive Vice President, Regions Financial Corp.

A

Yeah. Good morning, everybody. We added about 17 new initiatives to our Simplify and Grow list in the second quarter, bringing that number up to about 62 initiatives. We've already completed 13 year to date. We'll complete another 11 initiatives in the second half of 2019. When I think about some of the things we can point to, go back to Investor Day, we talked about launching our digital lending platform in the consumer side of the house. That has really taken traction. We're seeing 38% of our applications today come in through that digital channel. On the eSign, e-close part of this, we were up to about 58% of our direct loans. Closings of eSigns are really good traction on our digital lending capabilities.

On the account opening really on the digital front, the thing I'd point you to, we've had a team as part of Simplify and Grow working now for about a year on how do we streamline account opening, how do we make the credit card process a more smooth process and a quicker process. We've revised the application. We've streamlined. And we now are getting about 53% increase in our digital account openings and checking accounts and about a 44% increase in credit card production to that digital channel. So, really good traction there.

On the AI front, we continue to look for use cases on how we can roll out AI across the bank. You're all familiar with what we've done in the contact center. We've expanded a couple things in the contact center with AI. One of those is now we launched password resets, which is one of our top calls into the center. We launched that in this month and we're seeing really good traction in having our AI virtual agent handle those password resets.

The last thing is we're having good success with AI in our quality assurance functions, where we're actually having the AI virtual agent, quality assurance, the call types, the categories and really go through and make sure that our reps are following the right disclosures and right scripts. That's reduced our expenses in that QA area by about 70%, so good traction with AI as well.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good. Thank you.

Peter Winter
Analyst, Wedbush Securities, Inc.

Q

That's great. And then if I could ask, with the hedging strategy really you're starting to kick in beginning in next year and you gave the outlook for the margin in the first quarter. Should we expect the margin going forward next year to be kind of flat to up?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. I think the – to the extent – so we're all assuming that the forwards actually work their way through for next year. As you can see on the chart, I think it was slide 6 where we're trying to show you more and more hedging – more and more of the derivatives actually become effective which helps us stabilize margin. And what we're trying to do through the hedging program is just neutralize the impact of insurance policy on lower rates, which prevents us from having to grow net interest income and margin from coming out of a hole.

So, now you can have organic growth in the balance sheet putting on good earning assets that give you the kind of growth that you want to have. So, we're not having to work against, say, a headwind like we think many others might have. And so, we do have the ability to grow depending on what we put on in terms of earning assets in 2020.

Peter Winter
Analyst, Wedbush Securities, Inc.

Q

Great. Thanks a lot.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

Operator: Your next question comes from Ken Usdin of Jefferies.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Morning, Ken.

Ken Usdin
Analyst, Jefferies LLC

Q

Thanks. Good morning, guys. Good morning, guys. Thank you. Just a follow-up on that last question, so your scenario that you put out on page 5 which is really helpful bakes in the three potential cuts that are in the forward curve, and this might be just more of a semantic one. But I'm just wondering if the Fed only gives us one, how does that cadence change potentially in terms of the decline before the hedges come on? Like is it just that you end up in the same place, but from a slightly different way of getting there? Just trying to understand how the cadence might change if we don't fully get there, the three cuts in the curve.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. So, Ken, a couple things to think about our sensitivity. We really have two things working. First is, to your point, the short end of the curve. So, the short end of the curve is where our derivatives are tied to, generally speaking, one-month LIBOR. We have receive fixed. So, cuts in the short term with the protection on the receive fixed derivatives and our ability to reduce deposit cost in that 35% deposit beta that we are talking about gives us the confidence that we have at 2020. So, even if you have one, two, three cuts in the short end, we have protection under any of those scenarios.

Then the second part is what happens to the long end of the curve. And so, if we have slope to the curve, even in a lower rate environment if we have slope, we're protected as well because the reinvestment is coming off the investment portfolio and the like really are tied to the long end. What we don't want is to have a lower and flatter yield curve which is horrible for our industry as you know. So, we're not as concerned about whether it's one, two or three because we'll react appropriately as long as we can get the long end to, at least, stay where it is and maybe even increase a bit.

Ken Usdin
Analyst, Jefferies LLC

Q

Got it. So, regardless of the pacing then, you feel pretty good that that 1Q 2020 low-to-mid 3.20s (sic) [3.40s] (00:39:07) can happen in most any circumstance except for a meaningfully flatter curve environment?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

That's exactly right. And our protection – we've started putting this on over a year-and-a-half ago with the expectation that we were going to be in this environment, we just thought it would be beginning in 2020 which is why we did forward starting. We thought there were going to be rate increases through 2019 and we want to stay asset sensitive, so we've been caught a little bit exposed in the latter part of 2019 as have every peer of ours. But we're feeling pretty good about what can take place in 2020. And going forward, we have duration on those swaps and floors of five years beginning in 2020. So, we have really good protection then.

Ken Usdin
Analyst, Jefferies LLC

Q

Okay, got it. And then last just a cleanup on the – those forward starting swaps that – you've got the fixed rate strike on there. I mean, are they meaningfully different ones? The average is obviously 2.48% for the swaps and 2.08% for the floors on page 6. But as you put them on, are they all around kind of a general average there or are there – it depends upon which one they could be very much in or out of the money across the book?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah, the averaging that we've given you, so we went to disclose a lot more this time to give you the ability to do your models and we think the averaging is going to be representative enough. There'll be 25 points here or there, but nothing is really going to skew that from using the averages.

Ken Usdin
Analyst, Jefferies LLC

Q

Okay. Got it. Thanks, David.

Operator: Your next question comes from Erika Najarian of Bank of America.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning, Erika.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Hi. Good morning.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Good morning. I just wanted to clarify the response to Ryan's earlier question, as we think about the 35% deposit beta, given that deposit costs already peaked in May, is that for the initial 25 basis points? And as we think about 2020, what do you think – and if the forward curve is right in that we'll get three cuts and then maybe not anymore, what could the ultimate sort of reverse deposit beta be on the 75 basis points of cut?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah. I think we're going to start at 35%. I think, over time – we're at 29% cumulative going up. So, if you're starting at 35%, you would expect that to drift down a bit as time goes through. I think that's what you're asking.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Just to clarify, the initial impact is immediate in terms of the 35%, especially on the 20% of your interest-bearing deposits that you are identifying as either quite expensive or indexed, and then the repricing would taper off in terms of percentage of cuts rather than accelerate. I guess I'm...

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

You're exactly right. So, it starts at 35% and then at the end of day, you're going to drift from that 35% down into the higher 20s as at. And the driver of that is the 10% indexing at the exception pricing and then just looking at the market of all of our deposits as we compare to our peers. And we get the benefit of our floors and we get the benefit of our receive fixed swaps.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Got it. And, John, just wanted to clarify, I hear you loud and clear that 55% and below on efficiency is difficult in this rate environment. You did say something earlier as a reply to a question that flat to down slightly on expenses is still a commitment. And is that what we should think about over this three-year period, regardless of the rate environment?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yes. So, this is David. So, the flat to slightly down was an answer to 2019 change in our guidance there. I think your question is, well, then, what does it mean for the next three years if we're in this challenging revenue environment? We clearly – we have 2%, 2.5% inflation baked into our expense base every year. And so, we have to continue to see cuts. If we want to keep expenses relatively stable, we have to find ways to cut that 2.5%. And then if we want to make investments on top of that, we got to find even more.

Our commitment is that we would generate positive operating leverage under any of those environments each of those three years. Clearly, a lower rate environment, a flatter yield curve makes that very tough. But that's what we seek to do and we're going to do whatever it takes to meet the expectations that we've laid out. The commitment was 55% three years from now. We're only six months there, so we're not giving up on 55% by any stretch.

Erika Najarian
Analyst, Bank of America Merrill Lynch

Q

Got it. Thanks for that clarification.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

Operator: Your next question comes from Saul Martinez of UBS.

Saul Martinez
Analyst, UBS Securities LLC

Q

Hey. Good morning, everybody.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Morning.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Hi, Saul.

Saul Martinez
Analyst, UBS Securities LLC

Q

So, I guess I'm still a little bit confused on the 35% deposit data and the glide path thereafter for future cuts. So, are you saying that on the first 25 basis point cut you'll see a decline in your interest-bearing deposit cost of – or 35% beta on the decline on your interest-bearing deposit costs? And over what time period does that occur? Is that sort of an immediate decline or is that something that drags on over a couple quarters [ph] as repricing (00:45:01) filters in? Because it seems like the commentary from some other banks has been that there is going to be a lag in terms of deposit betas and that they're going to accelerate, not decelerate as further rate cuts happen.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Yeah. So, we felt like ours were going to happen a little quicker because of the indexing that we have on 10% of our $60 billion of interest-bearing deposits, another 10% exception price that we can move quickly, too. So, we think that can be pretty high early on and we think that that could be maintained perhaps for a couple of quarters. At some point, though, that has to taper off. We're only up to 29%. So, if you start at 35%, at some point it has to taper off as you get to an absolute floor in terms of deposit costs. So, does that help?

Saul Martinez
Analyst, UBS Securities LLC
Q

Yeah, I think so. So, the 35% then you're saying is pretty immediate [ph] at this point (00:46:01).

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

That's correct.

Saul Martinez
Analyst, UBS Securities LLC
Q

Okay. And I guess just more of a conceptual question then on NII and how to think about net interest income growth in 2020 and 2021 and I'm certainly not asking for guidance. I know it's too early for that. But to the extent you have stabilized your rate sensitivity, you've neutralized it to a large degree. When we think about NII growth beyond this year, should we be thinking net interest income grows more in line with loan growth, average earning balance growth and mix shift and that occurs not necessarily independently of rates, but that being a much bigger driver of net interest income growth, regardless of what the rate environment does?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

Well, that's exactly what we're trying to communicate that our hedging program is giving us the opportunity to not have to climb out of a hole to grow NII margin, rather neutralizes that. It was insurance protection of the low rate environment, not to give us a tailwind, but to keep us from having this massive headwind and, therefore, we could participate in to growing NII and margin as we continue to grow earning assets watching our deposit cost. Our deposit franchise is still our number one competitive advantage, and we think that's going to help us continue to grow NII with appropriate balance sheet growth.

Saul Martinez
Analyst, UBS Securities LLC
Q

Okay. No, that's helpful. I could sneak one quick final one in. I don't know if I missed it, but the outlook for indirect auto and indirect other consumer now that you've exited GreenSky – or not exited – not renewed the commitment there, how do we think about – can you remind us what your expectations are for balances there? And how much [ph] lines (00:48:01) and what the other consumer [ph] lines (00:48:03) balance should do?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

And so if you look at in our supplemental on page 21, you'll see our indirect vehicle declined this past quarter some $350 million. So, we're kind of on that kind of run rate. We're not renewing that. It'll take some time. The whole average for the year will be about $800 million on indirect auto decline. I'm sorry...

Saul Martinez
Analyst, UBS Securities LLC

Q

And I'm sorry. There's...

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

I said auto, I meant GreenSky.

Saul Martinez
Analyst, UBS Securities LLC

Q

Yeah. Oh, GreenSky, okay. Right. Thank you.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Yeah. We need to clarify that. I think it's $800 million on average on the indirect auto portfolio full year, right?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

That's right.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

And then, the runoff with respect to the indirect unsecured portfolio, it'll top out over the next month or two as that contract expires, and then we kind of expected two to two-and-a-half years sort of weighted average payout on that portfolio.

Saul Martinez
Analyst, UBS Securities LLC

Q

Great. Very helpful. Thank you.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

Operator: Your next question comes from Christopher Marinac of Janney Montgomery Scott.

Christopher William Marinac
Analyst, Janney Montgomery Scott LLC.

Q

Thanks.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Morning.

Christopher William Marinac
Analyst, Janney Montgomery Scott LLC.

Q

Good morning. I wanted to ask you about the environment for you to – late this year or next year about hiring teams of producers. Is this the environment where you invest in that or perhaps a few new markets come into the Regions footprint because of external opportunities?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Yeah. I mean, we're – all of our business leaders, well, commercial, corporate, real estate are actively recruiting all the time, our consumer business similarly. One of their task is to always know who the best bankers are in their markets and in contiguous markets, who the best bankers are in their specialized businesses. And so, we're always actively recruiting. I think we've had good success recruiting already this year across particularly our priority markets where we are investing, St. Louis, Atlanta, Houston and Orlando. And we'll continue to do that.

Christopher William Marinac
Analyst, Janney Montgomery Scott LLC.

Q

Okay. Great, John. Thanks very much.

Operator: Your next question comes from Kevin Barker of Piper Jaffray.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good morning.

Kevin J. Barker
Analyst, Piper Jaffray & Co.

Q

Good morning. I was hoping you can give us a little more color on the 9.5% CET1 ratio target for the third quarter. It would seem that would imply a pretty aggressive buyback this quarter and then maybe a tail-off through the rest of the CCAR cycle. And maybe just help us out with the cadence of the buyback in the near term and then through the cycle.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Yeah, Kevin, so you're exactly right. We've put into our prepared comments, we were going to get to our 9.5% in the third quarter, so we have loan growth that uses up some of that in dividends and then buying back to get us to that 9.5%. It won't be exactly that every single quarter. But we're going to do what we can to keep it at that level because that's the level of capital we think we need to run the company based on our risk profile. That does imply a quicker buyback or more of a buyback here in the short term. It will moderate after that.

And we will use the repurchase ability, so we have authorization for our board up to $1.37 billion of stock buyback. And how we think about capital allocation is, first and foremost we'll pay a dividend of 35% to 45% of our earnings. Then we're going to use some for organic loan growth, and then we'll use the rest, we'll buy stock back to keep us at that 9.5%. Should loans grow faster, buybacks will be smaller and vice versa. If loans don't grow, buybacks will increase, so that we can keep the capital optimized in the company.

Kevin J. Barker
Analyst, Piper Jaffray & Co.
Q

Okay. So, given the authorization that you have for this cycle, it would seem to imply that we keep the loan growth relatively low-single digits or somewhere very close to that or maybe even closer to stable in the near term. Is there anything you're doing within the balance sheet in order to decrease risk-weighted assets or some other way in order to keep the ratio at 9.5% given the buyback authorization you have in place?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.
A

No. Our teams are out there growing loans when it makes sense from a risk-adjusted return standpoint. We grew the first quarter a little quicker than we had expected. We slowed that down a bit this quarter. We still have the low- to mid-single digit growth expectation for the year. Again, any given quarter you can see a pace change. The third quarter for us over the last couple years has not been as stronger for growth even though our pipelines look pretty good. The fourth quarter, on the other hand, it's actually been pretty strong. So, we're sticking to that commitment on the loan growth.

And my point is that we use 9.5% and we toggle between loan growth and share buyback. We're not trying to manufacture one or the other. We want all the good – we would much rather use our capital to grow organically than to buy our stock back. But we also want to have appropriate risk-adjusted, client relationship type returns on the loan side. And if we don't get those and we can't use our capital to grow appropriately, we will buy our stock back if that makes sense.

Kevin J. Barker
Analyst, Piper Jaffray & Co.
Q

Yes. It does. All right. Thank you for taking my questions.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Thank you.

Operator: Your final question comes from Gerard Cassidy of RBC.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.
A

Morning, Gerard.

Gerard Cassidy
Analyst, RBC Capital Markets LLC
Q

Good morning. How are you?

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Good.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Question, can you guys share with us – we've seen a lot of commentary about the strength of the consumer business and we all know how low the unemployment rate is in this country and wage growth seems to be accelerating. But there seems to be some crosscurrents in the business side of our economy with what's going on with the trade negotiations, et cetera. So, can you give us some insights of what your business customers are sharing with you about their business? And could you tie that into the forward curve of three 25 basis point rate cuts in 2019? It just seems like the forward curve is being a little aggressive on those rate cuts. But I'm just curious to see what you guys think.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Well, to answer the second half of your question, no, we cannot tie it into the forward curve. I would tell you that our business customers are still cautiously optimistic. Clearly, over the last 90 days or so, I sense more caution on the part of our business owners, but they're still optimistic. Their 2018 results were very good. Most of them are having really good 2019s.

As we look at our credit quality across a variety of industry sectors, I really don't see any significant issues other than within the restaurant subsector, we've called out before fast casual, don't appear to be any other stresses of any consequence that we see. Customers have good pipelines. And so, as I think I've said in my prepared remarks, the primary constraint we see on the economy is the availability of skilled labor, and that's the thing that tends to constrain businesses from investing, not the interest rate environment. And so, I really can't tie our view of the economy through our customers' eyes to the forward rate curve.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Very good. And then, can you guys share with us an update on CECL, where you stand and when we may get a day one estimate on the buildup of reserves in January of 2020?

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Sure, Gerard. Our teams have been working really hard to run parallel this year. We're feeling good about being prepared for the adoption, obviously, January 2020. We're looking to put something in our 10-Q that would give some indication as to where we might be here shortly on day one.

As we've mentioned before, consumer portfolios get hit really hard relative to commercial portfolios. And so, we have about 40% of our consumer loans versus business services loans, so mortgages, HELOCs, credit cards, those unsecured credit, those get hit pretty hard in the CECL adoption, not as much on the commercial side. But just stay tuned here shortly on our 10-Q filing.

Gerard Cassidy
Analyst, RBC Capital Markets LLC

Q

Great. Thank you, John. Thank you, David.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

A

Thank you.

David J. Turner, Jr.
Senior Executive Vice President & Chief Financial Officer, Regions Financial Corp.

A

Thank you.

Operator: Thank you. I'll turn the call back over to John Turner for closing remarks.

John M. Turner, Jr.
President, Chief Executive Officer & Director, Regions Financial Corp.

Well, I thank everybody for their interest. I hope you can tell we think we had a solid quarter despite the volatility in the market. We're focused on things that we can control, client selectivity, sound underwriting, credit servicing, effective expense management, resource allocation and risk-adjusted returns. We have a good plan, we think, to neutralize our interest rate sensitivity. And we believe we're well positioned to continue to execute on our plans, and we stay focused on that. So, thank you for your interest in Regions, and have a great day.

Operator: This concludes today's conference call. You may now disconnect.